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# The Consequences of Expiring Commercial Shared-Loss Agreements

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# The Consequences of Expiring Commercial Shared-Loss Agreements

## I. INTRODUCTION

In November 2008, as the financial crisis worsened, and an increasing number of banks flat-lined, the FDIC responded by resurrecting shared loss agreements (SLA) as a mechanism for aiding in the disposal of failed bank assets.<sup>1</sup> Not seen since the Saving and Loan Crisis of the late 1980s and early 1990s, SLAs provided the necessary incentive for acquiring institutions<sup>2</sup> (AI) to take on the troubled assets of their fallen brethren.<sup>3</sup> Due to depressed asset values and investors' corresponding demand for steep liquidity and risk discounts at the time,<sup>4</sup> SLAs were an essential component of the resolution process that transferred the troubled assets of failed banks to healthy institutions.<sup>5</sup> The FDIC asserts that in many situations these agreements provided the least costly means for resolving failed banking institutions<sup>6</sup> because by providing coverage for future losses, they allowed the FDIC to sell troubled assets at prices closer to those in a normal, non-depressed market.<sup>7</sup>

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1. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REPORT TO CONGRESS, REP. EVAL-14-002, COMPREHENSIVE STUDY ON THE IMPACT OF THE FAILURE OF INSURED DEPOSITORY INSTITUTIONS, 7 (Jan. 2013), *available at* <http://fdicig.gov/reports13%5C13-002EV.pdf>. ("Faced with increasing failures, declining asset values, and losses that depleted the DIF, the FDIC reinstituted the use of SLAs in November 2008.").

2. Also referred to as "assuming institutions" at times.

3. OFFICE OF INSPECTOR GEN., *supra* note 1, at 20 ("The FDIC has reported that turmoil in the economy and significant uncertainty about future loan performance and collateral values necessitated the use of loss sharing, especially early in the crisis, because potential buyers of failing institutions were unwilling to take on the credit risk associated with potential buyers of failing institutions were unwilling to take on the credit risk associated with failed bank assets, without some form of loss protection.").

4. FDIC, *Loss-Share Questions and Answers*, <http://www.fdic.gov/bank/individual/failed/lossshare/> (last updated Oct. 2, 2013) [hereinafter *Loss-Share Questions and Answers*].

5. OFFICE OF INSPECTOR GEN., *supra* note 1, at 10.

6. FDIC Act of 1933, 12 U.S.C. § 1821(c)(4) (2012) (requiring the FDIC to resolve failing institutions in the least costly manner).

7. See OFFICE OF INSPECTOR GEN., *supra* note 1, at 24 n. 20; *Loss-Share Questions and Answers*, *supra* note 4 ("These agreements enable the FDIC to sell the assets today, but without requiring that the FDIC accept today's low prices.").

The SLAs presumably gave AIs the buffer necessary to work out the salvageable, troubled assets.<sup>8</sup> The five-year term of coverage was based on the presumption that the overall health of the economy would sufficiently rebound within the loss-sharing period and that many of the troubled assets would correspondingly regain value and stability.<sup>9</sup> But now as expiration nears, significant uncertainty remains as to the degree of economic recovery<sup>10</sup> and the health of remaining SLA assets.<sup>11</sup> With the coverage for commercial assets provided by the first agreements executed in 2009 coming to an end in 2014,<sup>12</sup> covered assets that remain troubled have placed AIs in a perilous position—forcing banks to contemplate the resolution of these remaining assets in strategic terms.<sup>13</sup> Indeed, present circumstances lead some to “wonder whether these deals<sup>14</sup> will fully pay off for acquirers.”<sup>15</sup> Although the presumption upon which the agreements were built—that overall improvement of the economy would have reached a point to eliminate the uncertainty surrounding the future of SLA assets—has proven to be

8. Telephone Interview with Lorraine M. Buerger, Schiff Hardin (Oct. 10, 2013).

9. FDIC, SUPERVISORY INSIGHTS 2 (2010) [http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum10/SI\\_sum10.pdf](http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum10/SI_sum10.pdf) (“The FDIC is making greater use of the loss-sharing agreements which not only allow the Corporation to sell failed bank assets at the time of failure, but also provide the opportunity to recover prior asset losses when market conditions improve.”).

10. See e.g., Jon Hilsenrath & Victoria McGrane, *Fed Opts to Stay the Course, for Now*, WALL ST. J. (Oct. 30, 2013), <http://online.wsj.com/news/articles/SB10001424052702303618904579167811643963976> (“Seeing a more uneven economic climate than they expected . . . Federal Reserve officials got cold feet Wednesday and decided to keep their signature easy-money program in place for the time being.”).

11. Rachel Witkowski, *Failed-Bank Buyers Grow Increasingly Eager to Unload Covered Loans*, AM. BANKER (Aug. 10, 2012, 3:21 PM), [http://www.americanbanker.com/issues/177\\_155/failed-bank-buyers-grow-eager-to-unload-covered-loans-1051750-1.html](http://www.americanbanker.com/issues/177_155/failed-bank-buyers-grow-eager-to-unload-covered-loans-1051750-1.html) (“We also find that while some of these loans are paying today, they may not be paying tomorrow or the next year.”).

12. Shannon Lambert, *Spotlight: Loss Share Agreements*, FEDERAL RESERVE BANK OF ATLANTA (2013), [http://www.frbatlanta.org/pubs/financialupdate/13q2\\_vp\\_loss-share\\_agreements.cfm](http://www.frbatlanta.org/pubs/financialupdate/13q2_vp_loss-share_agreements.cfm) (according to chart 1, in 2014 will expire SLA coverage will expire for the acquired commercial assets of 77 banks representing a combined originally acquired value of \$103.3 billion – the greatest value in a single year).

13. Lisa G. Quateman & Tracy M. Ginn, *FDIC Loss-Sharing Arrangements*, BANKNEWS (May 2013), [http://www.banknews.com/Single-News-Page.51.0.html?&no\\_cache=1&tx\\_ttnews%5Btt\\_news%5D=18910&tx\\_ttnews%5BbackPid%5D=185&cHash=ff58d81132](http://www.banknews.com/Single-News-Page.51.0.html?&no_cache=1&tx_ttnews%5Btt_news%5D=18910&tx_ttnews%5BbackPid%5D=185&cHash=ff58d81132).

14. Term “deals” referring to the acquisitions made by AIs with loss sharing.

15. Witkowski, *supra* note 11.

inaccurate and overly optimistic, alternatives for how AIs may deal with SLA assets have not changed, leaving AIs boxed in with few options.

Banks, as self-interested actors,<sup>16</sup> must respond rationally to the expiration of SLAs and are legitimately incentivized to take action to claim losses under the agreements, before being subjected to the full exposure of any remaining troubled assets.<sup>17</sup> As expiration dates approach on the commercial shared-loss agreements (CSLA), slow economic recovery and corresponding persistent asset uncertainty operate to influence the behavior of AIs managing remaining loss-share assets.

This Note examines the shifting incentives for AIs and affirms the legitimacy of their conduct on the eve of commercial loss-sharing expiration. Part II of this Note explains the evolution of loss sharing;<sup>18</sup> while Part III describes the structure of the SLAs used by the FDIC during the financial crisis, including information on how SLAs fit into the resolution process.<sup>19</sup> Part IV discusses the legitimacy of the use of SLAs.<sup>20</sup> Part V provides information on the collection process under the agreements.<sup>21</sup> Part VI combines the incentives and the behavior SLA expiration induces in an analysis that affirms the legitimacy of AIs prioritizing collection on SLAs prior to their expiration.<sup>22</sup> Part VII is a discussion of potential bulk SLA asset sales,<sup>23</sup> and Part VIII is a brief conclusion.<sup>24</sup>

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16. See Kerry Singe, *Acquiring Failed Banks, Squeezing Borrowers: BB&T Among Lenders Questioned by Judges, Commercial-Loan Customers*, CHARLOTTE OBSERVER (Dec. 22, 2012), <http://www.charlotteobserver.com/2012/12/22/v-print/3743261/acquiring-failed-banks-squeezing.html>. (“... banks that acquire failed [banks] are not supposed to be ‘philanthropic’ or forgive debt, said Pamela Farwig, deputy director of the FDIC’s Division of Resolutions and Receiverships.”).

17. Webinar: *FDIC Loss Sharing Arraignments: The End Game*, held by Situs, SNL Financial, & Polsinelli (Oct. 16, 2013) (on file with author); see also *infra* Part VI.A pertaining to the accounting and regulatory reporting for SLA assets.

18. See *infra* Part II

19. See *infra* Part III

20. See *infra* Part IV

21. See *infra* Part V

22. See *infra* Part VI

23. See *infra* Part VII

24. See *infra* Part VIII

## II. RESOLUTION OF INSOLVENT BANKS AND DEVELOPMENT OF SLA APPROACH

The desire to transfer increased numbers of failed bank assets to private, healthy banks and the corresponding techniques to effectuate that desire developed over the course of the Saving and Loan Crisis serve as the foundations for contemporary loss-sharing practices. As the number of banking failures climbed in the late 1980s, the FDIC recognized that while selling-off assets had not been a priority in the past, the strategy of retaining assets as receiver would prove disastrous<sup>25</sup> in an environment of increased bank failures.<sup>26</sup> During the Saving and Loan Crisis, the FDIC determined that private banks were better suited to manage a large portfolio of failed bank assets<sup>27</sup> and began to shift towards methods intended to transfer larger quantities of assets to healthy institutions.<sup>28</sup>

Prior to the 1980s, cash and cash equivalents were the only assets AIs would acquire “on an ‘as is’ basis at book value.”<sup>29</sup> Without loss-sharing, acquisition prices for a failed bank’s assets (other than cash) include steep liquidity and risk discounts,<sup>30</sup> reflecting a desire to limit “exposure to unexpected deterioration in the loan asset portfolio.”<sup>31</sup> The resulting, often “unrealistically low,” bids to acquire

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25. FDIC, RESOLUTIONS HANDBOOK, 21 (2003), <http://www.fdic.gov/regulations/laws/rules/5000-4700.html> (quoting L. William Seidman, *Full Faith and Credit: The Great S & L Debacle and Other Washington Sagas*, 100 (1993)) (“This was not a serious problem in an agency with very few failed banks, and when the FDIC insurance fund had lots of cash False But it could be disastrous as the number of bank failures increased False The strategy of holding on to assets would swallow up all our cash very quickly.”).

26. The Depositors Insurance Fund ensures the “sound, effective, and uninterrupted operation of the banking system” during times of crisis by guaranteeing the “safety and liquidity of bank deposits.” Stanley V. Ragalsevsky & Sarah J. Ricardi, *Anatomy of a Bank Failure*, 126 BANKING L.J. 867, 872 (Nov./Dec. 2009) (quoting H. Rep. No 2564, 81st Cong., 2d Sess. reported in 1950 U.S. Code Cong. & Ad. News 3765, 3765-3766.).

27. RESOLUTIONS HANDBOOK *supra* note 25, at 22.

28. RESOLUTIONS HANDBOOK *supra* note 25, at 24 (“Because of the tremendous increase in bank and thrift failures during the 1980s, the FDIC began to consider techniques and incentives to sell substantially more of the failed institution’s assets to the acquirer.”).

29. RESOLUTIONS HANDBOOK, *supra* note 25, at 20 (Cash equivalents are accounts that are readily convertible to cash).

30. *Loss-Share Questions and Answers*, *supra* note 4; RESOLUTIONS HANDBOOK, *supra* note 25, at 19-20 (“Because asset values are generally overstated in a failing bank or thrift, the FDIC’s ability to sell assets to an acquiring institution based on book value was limited.”).

31. Ragalsevsky & Ricardi, *supra* note 26, at 877.

failed bank assets limits the FDIC's ability to sell the assets and keep them in the private market.<sup>32</sup> In order to pass a greater amount of assets on to private banks and avoid prohibitively low bids, the FDIC began conducting valuation reviews aimed at establishing acquisition prices<sup>33</sup> that more accurately captured the risks associated with the assets of failed institutions.<sup>34</sup> In the financial crisis, the FDIC sought to further supplement the valuation process through loss sharing.<sup>35</sup>

The administration of loss-sharing assets aspect of SLAs also traces its evolution back to the Saving and Loan Crisis. In 1989 Congress established the Resolution Trust Corporation (RTC)<sup>36</sup> to act as receiver and conservator of insolvent thrifts, with the goal of resolving those assets that were not transferred to AIs.<sup>37</sup> Unlike the FDIC, which "emphasized the sale of the maximum amount of the failed bank's assets to the bank acquirer at resolution,"<sup>38</sup> the RTC passed troubled assets to willing AIs in a piecemeal fashion with the objectives of "maximiz[ing] the net present value return from the disposition of failed thrifts and their assets [and] minimiz[ing] the effect of such transactions on local real estate and financial markets."<sup>39</sup> The resolution process of failed banks in the most current crisis shared similar goals.<sup>40</sup> However,

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32. See Ragalsevsky & Ricardi, *supra* note 26, at 877 ("In a whole bank P&A transaction, the purchaser assumes all deposit liabilities, not just FDIC insured deposit liabilities. This gives 100 percent protection to uninsured depositors and results in unlimited deposit insurance coverage to all depositors at a higher resolution cost to FDIC. For these reasons, whole bank P&A transactions are often not the least cost resolution method for FDIC in comparison to other resolution options.").

33. RESOLUTIONS HANDBOOK, *supra* note 25, at 20.

34. RESOLUTIONS HANDBOOK, *supra* note 25, at 20 (established value by asset review performed by FDIC staff instead of relying on the recorded book value.); *Loss Share Questions and Answers* *supra* note 4.

35. Ragalsevsky & Ricardi, *supra* note 26, at 877 ("FDIC currently addresses this problem by offering loss sharing arrangements in P&A transactions.").

36. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

37. FDIC, MANAGING THE CRISIS - THE FDIC AND RTC EXPERIENCE 1980, 17 (1998), [hereinafter MANAGING THE CRISIS] *available at* <http://www.fdic.gov/bank/historical/managing/>.

38. MANAGING THE CRISIS, *supra* note 35, at 19.

39. MANAGING THE CRISIS, *supra* note 35, at 17. The RTC had a third objective to maximize the availability and affordability of residential real property for low- and moderate-income individuals, which is not relevant to the scope of this note. *Id.*

40. OFFICE OF INSPECTOR GEN., *supra* note 1, at 24 ("Preserving asset values should, in turn, minimize the impact that failed bank assets have on local markets. AIs are required to undertake loss mitigation efforts and to use their best efforts to maximize collections from assets, which helps support collateral values in the failed bank's market.").

through SLAs, AIs, rather than the FDIC or an RTC-like entity, were tasked with administering the troubled, as well as the sound, assets. The use of SLAs in purchase and assumption (P&A) transactions<sup>41</sup> induced AIs to acquire the failed institutions' less attractive troubled assets – thus supplanting the need for an RTC-like entity.<sup>42</sup>

### III. LOSS-SHARING COMPLEMENTING WHOLE BANK P&A TRANSACTIONS

The SLAs used in the financial crisis typically appeared as attachments to whole bank P&A agreements.<sup>43</sup> Once the FDIC has decided to close a particular banking institution, it evaluates the bank's assets and selects the least costly resolution method.<sup>44</sup> Of the resolution methods available to the FDIC,<sup>45</sup> the P&A transaction is the preferred,<sup>46</sup> and most frequently utilized, method.<sup>47</sup> A P&A transaction may be structured in a variety of ways depending on the assets to be acquired, the liabilities involved, and the incentives offered. Most P&A transactions can be categorized by the portion of the failed institution's assets to be acquired and are classified as either a whole bank transaction—where most of the failed bank's assets and liabilities are acquired—or a modified/clean bank form in which the transaction involves acquisition of only the failed bank's core FDIC insured deposits with the AI paying a premium for the value of the future

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41. RESOLUTIONS HANDBOOK, *supra* note 25, at 33 (indicating that SLAs can be combined with other types of resolution agreements).

42. Damian Paletta, *Raft of Deals for Failed Banks Puts U.S. on Hook for Billions*, W. ST.J., Aug. 31, 2009, <http://online.wsj.com/news/articles/SB125166830374670517> (“During the savings-and-loans crisis . . . the government set up the Resolution Trust Corp. to take over assets from failed banks and sell them. Such a structure doesn't exist now, which means that the FDIC has to take on those assets or somehow persuade healthy banks to do so.”).

43. OFFICE OF INSPECTOR GEN., *supra* note 1, at 10.

44. Ragalsevsky & Ricardi, *supra* note 26, at 868.

45. FDIC Act of 1933 § 13(c)(4), 12 U.S.C. § 1823(c)(4) (2012) (listing legal options for bank resolution. Since 1991 the FDIC is required by law to chose the least costly method.).

46. RESOLUTIONS HANDBOOK, *supra* note 25, at 27 (“The FDIC's preference for passing assets to acquirers became formal corporate policy on December 30, 1986. The FDIC Board of Directors established an order of priority, known as ‘sequential bidding,’ for six alternative transaction methods based on the amount of assets passed to the acquirer.” (whole bank purchase and assumption listed as the first in list of six organized in order of preference)).

47. Ragalsevsky & Sarah, *supra* note 26, at 876.

depositor relationships.<sup>48</sup>

Whole bank P&A transactions offer advantages in efficiency and the ability to quickly “reduce the number of assets held by FDIC for liquidation and their associated liquidation costs.”<sup>49</sup> Since AIs assume all of the failed bank’s assets in a pure whole bank P&A, “including bad loans, on an ‘as is’ basis at book value,” bids are conservative and often negative.<sup>50</sup> The addition of loss-sharing to a whole bank P&A transaction alleviates to some degree overly pessimistic hedging that results in low bids. Loss-sharing discourages “unrealistic low bids” in a whole bank P&A by addressing the difficulty of valuing failed bank assets in an uncertain economic environment.<sup>51</sup> Instead of disproportionally discounting the price of assets to compensate for financial uncertainty, and to further mitigate the risks associated with the limited time to conduct due diligence, the reluctance to acquire portfolios of loans underwritten by a failed institution, and the inherent uncertainty of commercial real estate markets, the FDIC incentivizes the transfer of all of the assets by agreeing to share in the future losses that exceed a discounted price threshold associated with a fixed pool of troubled assets.<sup>52</sup> Loss-sharing facilitates a whole bank P&A transaction by encouraging an AI to take on assets it would otherwise not acquire at a price acceptable to the FDIC.<sup>53</sup> In turn, by including more overall assets in the transaction, the ratio of liabilities to assets is decreased – even if those assets are considered troubled.

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48. *Id.*

49. *Id.* at 877.

50. *Id.*

51. *Id.* at 879 (“Loss sharing encourages bidding based on an accurate valuation of assets, and thus allows FDIC to maximize the bank’s value while at the same time disposing its assets efficiently. It discourages unrealistically low bids designed to hedge against the risk of greater than anticipated losses.”); OFFICE OF INSPECTOR GEN., *supra* note 1, at 24 (“During the crisis, SLAs helped to preserve asset values and reduce the FDIC’s resolution costs. Asset prices were low and investors were demanding steep liquidity and risk discounts when bidding on failed bank assets. In such circumstances, loss-sharing guarantees enabled the FDIC to sell failed bank assets at prices closer to their intrinsic value instead of accepting depressed prices.”); Paletta, *supra* note 39 (quoting Len Williams, chief Executive of Home Federal Bank) (“The hardest part today in the acquisition game is valuing assets for determining real equity, and with a loss share you can do that”).

52. RESOLUTIONS HANDBOOK, *supra* note 25, at 29.

53. See *infra* Part III.



A. *Structure of SLAs*

“Assets in a loss-sharing transaction are valued at the failed bank’s book value plus a premium or minus a discount offered by bidders;” accordingly, an AI may either pay the FDIC for the assets or actually receive a payment from the FDIC.<sup>54</sup> In a whole bank P&A with loss-sharing, the initial cash exchange is determined by combining the “asset premium or discount bid, the franchise value bid for the failed institution’s deposit base, and the difference between the book values of the assets acquired and the liabilities assumed from the failed institution.”<sup>55</sup> If the sum is a negative amount, the FDIC makes a payment of that amount to the acquirer.<sup>56</sup> If the sum is a positive number, “the amount represents the amount of loss the bidder is willing to absorb on the purchase of assets and assumptions of liabilities of the failed bank before receiving FDIC loss share protections” and the AI makes an upfront payment of that amount to the FDIC.<sup>57</sup> In many transactions, the upfront payment by the AI establishes a first loss threshold—essentially serving as a deductible—with the FDIC providing loss coverage once losses exceed the amount paid.<sup>58</sup>

Troubled assets are categorized as either single-family home assets or commercial assets, with each pool provided with loss-sharing protection under separate SLAs. Single-family home mortgage related assets are protected from losses associated with modifications, short sales, foreclosure sales, and charge-offs for a ten-year span.<sup>59</sup> SLAs for commercial assets provide loss coverage for a five-year period, while recoveries are shared during the course of loss-sharing plus an additional three years subsequent.<sup>60</sup> A typical SLA is structured in such a way that the FDIC reimburses 80% of the losses on the specified pool of assets, while the acquiring institution absorbs the remaining 20% of

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54. *FDIC Changes Loss Sharing on Failed Bank P&As*, JONES DAY (March 2010) [hereinafter JONESDAY], <http://www.jonesday.com/files/Publication/4a941df1-3ee2-4b37-889b-237de0410da6/Presentation/PublicationAttachment/4a389701-81e6-436e-8af4-32aad2cbeb9c/FDIC%20Changes%20Loss-Sharing.pdf>.

55. FDIC, *supra* note 9, at 4.

56. *Id.* at 3.

57. JONESDAY, *supra* note 54.

58. FDIC, *supra* note 9, at 3.

59. OFFICE OF INSPECTOR GEN., *supra* note 1, at 21.

60. FDIC, *supra* note 9, at 3.

losses.<sup>61</sup> SLAs entered into prior to April 2010 provided for an increase in reimbursements from 80% to 95% once aggregate losses exceeded an upper-loss threshold.<sup>62</sup> The FDIC makes payments for losses on covered assets when, and if, the acquiring institution charges-off the assets in accordance with applicable standards.<sup>63</sup>

*B. Commercial SLAs of the Financial Crisis*

At the time of the financial crisis, commercial real estate (CRE) loans made up more than one-third of community bank lending.<sup>64</sup> An unhealthy concentration of CRE loans was a common attribute among failed institutions, often serving as the primary reason for institutional failure.<sup>65</sup> The same CRE assets that contributed so profoundly in the demise of institutions, have continued to play a pivotal and persistent role in the process of resolving their past benefactors.

Because high concentrations of CRE loans were such a common feature of failed institutions, loss-sharing relating to commercial assets became a prevalent aspect of resolution efforts. Since 2009, loss-sharing for commercial assets has been used in the resolution of 307 failed banks<sup>66</sup> with a combined initial asset value of \$214.8 billion of which \$91.3 billion remains currently covered.<sup>67</sup> A majority of those agreements will expire in the next two years. Loss-sharing for the seventy-seven transactions that utilized CSLAs in 2009 with a combined initial value of \$103.3 billion will expire in 2014; and in the following year, the CSLAs used in the resolution of 126 failed bank resolutions in 2010 with an initial value of \$62 billion will also expire.<sup>68</sup> As of September 24, 2013, \$6.8 billion in covered commercial loans were past due and in nonaccrual status.<sup>69</sup>

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61. Ragalsevsky & Ricardi, *supra* note 23.

62. *Id.*

63. FDIC, *supra* note 9, at 3; *See Infra* Part V for SLA collection process.

64. OFFICE OF INSPECTOR GEN., *supra* note 1, at 2.

65. OFFICE OF INSPECTOR GEN., *supra* note 1, at 2 (“[L]osses in ADC and other types of CRE loans, often related to residential real estate lending, figured prominently in many smaller institution failures.”).

66. FDIC, *Failed Banks/Loss Share Agreements*, [http://www.fdic.gov/bank/individual/failed/banklist\\_lossshare.html](http://www.fdic.gov/bank/individual/failed/banklist_lossshare.html) (last updated Dec. 24, 2013) (one bank used a CSLA prior to 2009 in 2008).

67. *Id.*

68. Webinar, *supra* note 17.

69. *Id.*

## IV. LEGITIMACY OF THE USE OF LOSS-SHARING

In times of increased institutional failure, such as the financial crisis, SLAs provide an affordable means of incentivizing the retention of failed bank assets in the private banking sector.<sup>70</sup> “Banks are capable of managing significant levels of distressed assets in a fashion that can facilitate orderly liquidation,”<sup>71</sup> and exploiting this capability by placing the burden of administering troubled assets with private banks, instead of with the FDIC, reduces total resolution costs which in turn lessen the overall cash burden on the Deposit Insurance Fund (DIF)<sup>72</sup> itself.<sup>73</sup>

Bank failures cause broad disruption to both borrowers and local markets in general; because SLAs allow the FDIC to sell assets to other private institutions, the overall disturbance to both consumers and surviving institutions is reduced, enabling the failed bank’s borrowers to remain in the local banking market.<sup>74</sup> In the absence loss-sharing, AIs may have otherwise refused to acquire the troubled assets of a failed institution at a price acceptable to the FDIC. Consequently, those unacquired troubled assets would have either been retained or liquidated by the FDIC.<sup>75</sup> Subsequent liquidation would have driven down the market value of similar collateral of other surviving institutions in an already suffering economy.<sup>76</sup> Overall, the use of SLAs enabled the FDIC to include more failed bank assets in P&A transactions, which prevented the use of other resolutions methods that would have further depressed asset values in the market.<sup>77</sup>

Crucial to the soundness of loss-sharing as a legitimate resolution method is the inherent structural alignment of AIs’ incentives with those of the FDIC. The fundamental sharing aspect of SLAs induces<sup>78</sup> rational and responsible credit management behavior from

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70. OFFICE OF INSPECTOR GEN., *supra* note 1.

71. Richard B. Gaudet, *Loss-Sharing Agreements Between the FDIC and Acquiring Banks: Advice for the Borrower*, 29 ABI J., 1 (2010).

72. Quateman & Ginn, *supra* note 13.

73. Ragalsevsky & Ricardi, *supra* note 26, at 875.

74. OFFICE OF INSPECTOR GEN., *supra* note 1, at 22 (“Without SLAs to attract potential acquirers of failing institutions, the FDIC would have been forced to take ownership of the failed institution’s assets and liquidated those assets, which has historically resulted in greater disruption to local markets and been more costly”).

75. *Id.*

76. *Id.*

77. *Id.* at 21.

78. Loss Share Questions and Answers, *supra* note 4 (“[T]he FDIC sells to assuming

AIs as they seek to avoid unnecessary losses of any proportion.<sup>79</sup> Although critics allege that since AIs are not subject to a majority of the losses associated with a particular failed loan they are less likely to modify the loan,<sup>80</sup> the FDIC Office of Inspector General found<sup>81</sup> that SLAs either encouraged or had no impact on AIs' rate of loan modifications.<sup>82</sup> The FDIC also asserts that AIs have an additional incentive to work with borrowers to restructure troubled loans in order to establish ongoing relationships and thus capitalize on the expanded client base gained in the acquisition.<sup>83</sup> Aside from the incentives born of the loss-sharing structure, the actual terms of the agreements themselves expressly mandate obligations that increase the probability AIs will make appropriate efforts to modify loans, preventing an institution from prematurely claiming losses.<sup>84</sup> The combined structural incentives and agreed to obligations found in SLAs impart credible asset management into the privately administered resolution process making loss sharing a valuable resolution tool in times of financial turmoil.

## V. COLLECTION OF LOSSES UNDER SLAS

Collection on a SLA is warranted when the net charge-offs<sup>85</sup> on

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banks in a way that aligns their incentives with the FDIC and reduces the liquidity and risk discounts. The assuming banks have the capacity and incentive to service the assets effectively and minimize losses.”); see Telephone Interview with Lorraine M. Buerger, *supra* note 8 (“No bank is going to embrace those losses if there is another path”); Paletta, *supra* note 39 (“FDIC officials maintain that because banks still have a ‘material’ exposure, they will be reluctant to [put little effort into reworking the soured loans]”).

79. RESOLUTIONS HANDBOOK, *supra* note 24 at 30.

80. Singe, *supra* note 16.

81. Pub. L. No. Law 112-88, 125 Stat. 1899 (2012) (Required the Office of Inspector General of the FDIC to study the impact of loss-sharing on the insured depository institutions that survived and the borrowers of the insured depository institutions that failed.).

82. OFFICE OF INSPECTOR GEN., *supra* note 1, at 28.

83. *Id.*

84. *Id.*

85. See Bank Purchase and Assumption Agreement for Alliance Bank among FDIC and California Bank & Trust, 82 FDIC (Feb. 6, 2009), [hereinafter Purchase and Assumption Agreement], available at [http://www.fdic.gov/bank/individual/failed/alliance\\_P\\_and\\_A.pdf](http://www.fdic.gov/bank/individual/failed/alliance_P_and_A.pdf) (defining Net Charge-Offs as “an amount equal to the aggregate amount of charge-offs for such period less the amount of recoveries for such period”). The loss-sharing agreement is typically referenced in the purchase and assumption agreement and attached as an exhibit. The rules referenced herein related to the administration of loss-share assets are those that were typical in a loss-sharing agreement from 2009.

the covered assets, plus any other miscellaneous categories of allowed expenses,<sup>86</sup> result in a positive figure.<sup>87</sup> Charge-offs occur when a particular asset suffers an adverse classification under the examination criteria<sup>88</sup> of the bank's chartering authority.<sup>89</sup> Essentially an AI realizes losses, compensable under the agreements, in the course of compliance with the required regulations of their financial supervisory authority.<sup>90</sup>

*A. Final Resolution Events and Partial Charge-Offs*

AIs have several regulatory and legal methods available to trigger a loss-share collection event. A final resolution event, in which all efforts to make the loan work have failed, offers complete certainty in calculating losses because once the asset is disposed of, all possible losses have been realized, and there is no longer any uncertainty of further costs or losses.<sup>91</sup> The traditional final resolution event is a bank foreclosure on the loan's collateral as a means to recover the balance on the loan.<sup>92</sup> Alternatively, other final resolution events, such as short sales or discounted pay-offs, may serve as disposition methods for loans that otherwise do not qualify for modification efforts.<sup>93</sup> While the

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86. *Id.* at 87 (listing other reimbursable expenses).

87. *Id.* at 90.

88. *Id.* at 8 (defining Charge Offs as "an amount of loans or portions of loans classified as 'Loss' under the Examination Criteria," with respect to any Shared-Loss Assets for any period").

89. *See id.* (defining Examination Criteria as the "the loan classification criteria employed by, or any applicable regulations of, the Assuming Bank's Chartering Authority at the time such action is taken, as such criteria may be amended from time to time").

90. *See* FDIC, RSAM GUIDANCE 2013-G005, RISK SHARING ASSET MANAGEMENT GUIDANCE: WORKOUTS FOR ACQUIRED COMMERCIAL REAL ESTATE SHARED-LOSS LOANS, n.2 (May 28, 2013), available at [http://www.fdic.gov/bank/individual/failed/lossshare/RSAM\\_Guidance\\_2013-G005\\_Commercial\\_Real\\_Estate.pdf](http://www.fdic.gov/bank/individual/failed/lossshare/RSAM_Guidance_2013-G005_Commercial_Real_Estate.pdf)

(explaining that the financial regulators consist of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee); Telephone Interview with Lorraine M. Buerger, *supra* note 8 ("Working the loans as required").

91. *See* Telephone Interview with Lorraine M. Buerger, *supra* note 8.

92. *Id.*

93. *See* FDIC, RSAM GUIDANCE 2010-009, COMMERCIAL LOSS MITIGATION GUIDANCE, COMMERCIAL REAL ESTATE (CRE) LOANS, 6 (Dec. 17, 2010), available at [http://www.fdic.gov/bank/individual/failed/lossshare/Guidance\\_RSAM-2010-009\\_Commercial\\_Loss\\_Mitigation\\_Guidance.pdf](http://www.fdic.gov/bank/individual/failed/lossshare/Guidance_RSAM-2010-009_Commercial_Loss_Mitigation_Guidance.pdf).

certainty of a final resolution event is advantageous, it is a difficult point to reach within the five-year span of SLA coverage.<sup>94</sup>

AIIs have plenty of opportunities to monetize SLAs without a final resolution event through partial resolution events.<sup>95</sup> Losses due to mark to market calculations and regulator mandated losses matriculated through servicing a loan are two of the most frequent causes of appropriate charge-offs. Additionally, necessary loan modifications may trigger a partial loss event and subsequent SLA payout.

Mark to market value reductions are the primary means for short-term monetization of SLAs.<sup>96</sup> Contrary to book value, mark to market value is a reflection of actual present value.<sup>97</sup> Loans, such as those acquired in P&A transactions, are “evaluated and marked down when there is a change in the credit relationship.”<sup>98</sup> As a result of a credit event, examination criteria demands an updated appraisal of collateral to reflect the reduction in the loan’s collateralization with a corresponding reduction in the value of the secured asset in subsequent regulatory reports.<sup>99</sup>

Partial charge-offs that constitute a partial resolution event also occur in the course of an AI’s regular maintenance of an acquired loan. As a means to avoid unexpected losses, regulatory authorities mandate that banks actively monitor loans to ensure borrowers are able to fulfill the obligations under the loan terms.<sup>100</sup> The primary focus when assessing an outstanding loan is to determine the borrower’s ongoing ability to meet the contractual repayment obligations of the loan agreement.<sup>101</sup> A legal guarantor with the financial capacity and willingness to support the borrower may counter the effects of a poorly situated borrower.<sup>102</sup> Another factor involved in the analysis of outstanding loans is “the cash flow potential of the underlying collateral

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94. See Telephone Interview with Lorraine M. Buerger, *supra* note 8.

95. *Id.*

96. *Id.*

97. BARRON’S DICTIONARY OF BANKING TERMS 290 (5th ed. 2006).

98. *Id.*

99. See Telephone Interview with Lorraine M. Buerger, *supra* note 8.

100. *Id.*

101. FED. RESERVE BD., POLICY STATEMENT ON PRUDENT COMMERCIAL REAL ESTATE LOAN WORKOUTS, 4 (Oct. 30, 2009), *available at* <http://www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf>.

102. *Id.*

or business.”<sup>103</sup> “As the primary sources of loan repayment decline,” and the likelihood that the institution may have to seek repayment through sale of the collateral property increases, “the importance of the collateral’s value as a secondary repayment source increases in analyzing credit risk.”<sup>104</sup> If a bank in the course of this process is unable to verify how a borrower will be able to repay the loan or finds repayment is less likely than originally believed, the loan could be adversely classified for regulatory purposes.<sup>105</sup> If the bank determines a loan should suffer an adverse classification, a partial monetization of the SLA will occur in accordance with the particular classification.<sup>106</sup> The National Bank Examiners’ risk classification system<sup>107</sup> classifies poorly performing loans across categories of loss assets, resulting in a complete write-off; doubtful assets, warranting a fifty percent write-off from book value; substandard assets; and special mention assets.<sup>108</sup> The loss sharing collection would correspond to the appropriate charged off amount.

*B. Characteristics of Covered Loans Subject to Adverse Classification*

There are several types of loans that display patterns of characteristics that commonly warrant adverse classification. Troubled CRE loans that are dependent on the sale of collateral for repayment should be classified a loss for “any portion of the loan balance that exceeds the amount adequately secured by the market value of the real

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103. *Id.*

104. *Id.* at 8.

105. See Telephone Interview with Lorraine M. Buerger, *supra* note 8.

106. *Id.*

107. The Council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB), and to make recommendations to promote uniformity in the supervision of financial institutions. In 2006, the State Liaison Committee (SLC) was added to the Council as a voting member. The SLC includes representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS). FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, <http://www.ffiec.gov> (Dec. 18, 2013, 3:54 PM).

108. BARRON’S, *supra* note 97, at 11.

estate collateral, less the costs to sell” the property.<sup>109</sup> There are cases of CRE loans with short maturities that require extended financing, but even if the borrower has the ability to service the debt, the borrower may be unable to secure such financing due to deterioration in collateral values.<sup>110</sup> In these situations, a loan restructuring or modification may be the in the best interest of all parties,<sup>111</sup> but the restructured loan may nonetheless be subject to an adverse classification and a corresponding SLA collection.<sup>112</sup>

More severe assessments occur when an institution determines that a “well-defined [credit] weakness exists that jeopardize[s] collection in full [which] may result in a partial charge-off as part of a restructuring.”<sup>113</sup> Even loans that are contractually current may be subject to adverse classification, if the repayment of the principal is at risk.<sup>114</sup> This could be the case when the “loan’s underwriting structure or the liberal use of extensions and renewals mask credit weaknesses.”<sup>115</sup> Other loans, though not in default, may be candidates for modifications if a modification review request determines there is a low probability of performance.<sup>116</sup> Often a charge-off and corresponding SLA collection will accompany a modification.<sup>117</sup>

### C. *Preference for Final Resolution Events*

In most cases the ultimate goal of an AI seeking to collect on loss-share assets is to reach a final resolution event.<sup>118</sup> The most significant distinction between partial and final resolution events for SLA purposes is the uncertain future costs associated with partial monetization. The uncertainty that exists between partial and final resolution is “where the pain and conflict lurks” for AIs.<sup>119</sup> Those assets that have only been partially resolved at the time loss-sharing expires

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109. FED. RESERVE BD., *supra* note 101, at 8.

110. *Id.* at 8.

111. *Id.*

112. *Id.* at 9.

113. *Id.*

114. *Id.* at 8.

115. FED. RESERVE BD., *supra* note 101, at 8.

116. FDIC, *supra* note 93, at 6.

117. See Telephone Interview with Lorraine M. Buerger, *supra* note 8.

118. *Id.*

119. *Id.*



have the potential to expose the AI to additional costs subsequent to SLA expiration. On the other hand, once a final resolution event has occurred, an asset no longer has the potential or risk of generating future losses.

The desire to reach final resolution is complicated by the fact that it is common in failing bank environments that inadequate past maintenance<sup>120</sup> on loans has created a backlog of tasks that an AI must makeup.<sup>121</sup> This backlog of tasks makes reaching a final resolution, so that an AI may collect on a SLA, work intensive.<sup>122</sup> With expiration nearing for covered commercial assets and the task of marking losses becoming all the more a priority, AIs must ensure they assign sufficient importance to accomplishing the necessary tasks needed to collect sooner rather than later.

#### VI. SHIFT IN COLLECTION BEHAVIOR AND THE NEED TO MONETIZE SLAS

The rules for collection under SLAs found in the agreements are brief and appear simple in theory, but actual compliance has proven to be complicated. The agreements require the bank to exercise usual and prudent business and banking practices, act in accordance with the bank's practices and procedures, exercise best business judgment, and use best efforts to maximize collections in the administration of the loss-share assets.<sup>123</sup> These rules indicate that the FDIC expects the acquiring bank to administer the loss-share assets simply by acting as a bank managing loans using typical sound business judgment.<sup>124</sup>

Now, as expiration nears and the future of covered assets remains uncertain, banks should display a growing urgency to establish the true value of the loans so that any losses can be recognized before coverage expires.<sup>125</sup> While this may appear as merely an obvious continuation of what AIs have been doing since initially acquiring the

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120. Lenders continuing obligations to analyze a loan's performance.

121. See Telephone Interview with Lorraine M. Buerger, *supra* note 8; OFFICE OF INSPECTOR GEN., *supra* note 1, at 9 ("Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and controls.").

122. Telephone Interview with Lorraine M. Buerger, *supra* note 8.

123. See Purchase and Assumption Agreement, *supra* note 85, at 98-100.

124. Gaudet, *supra* note 71, at 3 ("[T]he FDIC has contracted with the acquiring bank to do what the bank does best: manage loans.").

125. See Telephone Interview with Nathan Stovall, SNL Financial (Sept. 23, 2013).

assets, at this point there is a substantial shift in the underlying motivation of asset administration. Maximizing collections could fairly be recast as “exhausting all available collection efforts.”<sup>126</sup> Essentially, as expiration approaches AIs should look to “cross all the t’s on the FDIC’s list” to demonstrate collection efforts have been made, have failed, and payment is necessary under the agreement.<sup>127</sup>

*A. Why Banks Need to Monetize SLAs Before Expiration*

Once loss sharing expires, the health of the remaining acquired assets will be fully reflected in the financial reports of AIs. SLAs affect how banks report both their overall financial health, as it relates to profitability, and their capital adequacy<sup>128</sup> for regulatory purposes. For purposes of general financial reporting, an institution with a SLA accounts for the potential payments under the agreement by listing an indemnification asset.<sup>129</sup> As a bank actually incurs losses on the acquired assets and subsequently charges the losses off, necessitating a collection under the SLA, it attributes those actual collections to income, while simultaneously charging-off and reducing the previously recorded indemnification asset.<sup>130</sup> Repayment periods of loans protected by a SLA typically extend beyond the protection period, thus requiring the corresponding indemnification asset to be amortized over the course of the SLA,<sup>131</sup> “thereby preventing a residual asset at the

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126. Gaudet, *supra* note 71, at 3.

127. See Telephone Interview with Nathan Stovall, *supra* note 124 (suggesting that the FDIC demanded a substantial threshold or showing that the cover loans had been “worked.”).

128. BARRON’S, *supra* note 97, at 74 (“Capital Adequacy: amount of capital relative to financial institution’s loans and other assets. Almost all banking regulators require that banks hold a certain minimum of equity capital against their risk-weighted assets.”).

129. FASB Exposure Draft Clarifies Indemnification Asset Accounting, RUBINBROWNLLP, (June 2012), <http://www.rubinbrown.com/component/content/article/239-a-a-a-alert-june-2012/2120-fasb-exposure-draft-clarifies-indemnification-asset-accounting> (“The recognition of an indemnification asset (an intangible asset) when a seller indemnifies a buyer against losses on specific acquired assets. The indemnification asset derives its value from, and is inversely related to, the expected future cash flows associated with the underlying indemnified purchased asset, such as an account or loan receivable.”); Nathan Stovall & Salman Aleem Khan, *Why More Banks Will Take Loss-Share Hits*, SNL FINANCIAL, 1 (Apr. 24, 2013), <http://www.snl.com/InteractiveX/Article.aspx?cdid=A-17533621-13359>.

130. See Telephone Interview with Nathan Stovall, *supra* note 124.

131. FINANCIAL ACCOUNT STABILITY BOARD, ACCOUNTING STANDARDS UPDATE NO.

maturity date of the indemnification agreement which would occur as a result of an amortization period exceeding the agreement.”<sup>132</sup> Therefore, when loss-sharing protection expires, so do the accounting benefits associated with the indemnification classification of SLA assets. Following SLA expiration those remaining troubled assets will reflect their full, unprotected weight in subsequent financial reports.

In addition to having to bear all of the losses on the pool of assets, the expiration of SLAs will impact the capital requirements of AIs.<sup>133</sup> Since a SLA provides that the FDIC take 80% of the losses on the covered pools of assets, the net exposure of those covered assets for capital adequacy purposes is weighted at only 20%.<sup>134</sup> Thus, once loss-sharing expires and the indemnification asset ceases to exist, the acquired assets that are only risk weighted at 20% under the SLA will experience a shift in risk allocation to account for the entire weight of the loan. The assigned risk weight will increase to 100%, or in cases of certain high-volatility CRE loans, to 150%, exposing the bank to the full liability of the remaining assets.<sup>135</sup> Since many of the covered commercial assets are speculative CRE loans,<sup>136</sup> instances of risk weighting in excess of 100 percent could be prevalent.<sup>137</sup> Because even the healthiest acquired loans often run a greater risk of being classified risky in the future (post SLA) compared to those originated by the AI,<sup>138</sup> the possibility of banks recording impairments that result in earnings volatility and possibly eventual losses is considerable.<sup>139</sup>

Nonetheless, there is no guarantee that banks will necessarily record impairments related to the once-covered assets, and no guarantee

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2012-06, BUSINESS COMBINATIONS (TOPIC 805) SUBSEQUENT ACCOUNTING FOR AN INDEMNIFICATION ASSET RECOGNIZED AT THE ACQUISITION DATE AS A RESULT OF A GOVERNMENT-ASSISTED ACQUISITION OF A FINANCIAL INSTITUTION, (Oct. 2012), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175824704251&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> (Issuance of clarification on accounting for indemnification assets related to SLAs.).

132. Stovall & Khan, *supra* note 128.

133. Quateman & Ginn, *supra* note 13.

134. Sarim Khan & Bill Warlick, *FDIC Loss-Sharing expiration little threat to U.S. Banks*, FITCHRATINGS, (Jul. 23, 2013), [http://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/FDIC-Loss-Sharing-Expiration?pr\\_id=797437](http://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/FDIC-Loss-Sharing-Expiration?pr_id=797437).

135. Khan & Warlick, *supra* note 133.

136. OFFICE OF INSPECTOR GEN., *supra* note 1, at 1.

137. *Id.* at 3.

138. Witkowski, *supra* note 11.

139. Stovall & Khan, *supra* note 128.

those assets that do result in impairments may not produce offsetting income in the future.<sup>140</sup> The question becomes: will banks risk the uncertainty of collecting uncertain future revenue and potential consequences, while guaranteed collection under the shared loss agreements remains a viable option?

*B. What Type of Conduct Can be Expected and Why It is Rational*

Without a more robust economic recovery, AIs are incentivized as SLA expiration nears to operate along a spectrum of increased rigidity in their willingness to work with borrowers on covered loans. The incentivized behavior materializes in a change from AIs striving to maximize collections to AIs “exhausting all available collection efforts” so that they may collect under the agreement.<sup>141</sup> With this change, lenders are not incentivized to be commercially sensible in dealing with borrowers in the normal sense of banking and<sup>142</sup> borrowers can expect less accommodation from lenders.<sup>143</sup>

It is difficult to know exactly what particular actions lenders will take in the run-up to the expiration of loss-sharing; nonetheless, it is reasonable to expect a general reluctance from AIs to continue to willingly support modification efforts and other accommodations for borrowers with nonperforming loans. For instance, if a covered troubled loan has been in work-out mode for the last three to four years and refinancing the loan is not possible because the loan remains under-collateralized, with loss-sharing expiring the rational course of action is to hedge risks and losses by making every effort to collect under the SLA.<sup>144</sup> While this shift may seem to be unfair or even malicious towards borrowers, this course of action is not only allowable under the agreements, but also enjoys support from the FDIC and industry insiders. Pamela Farwig, Deputy Director of the FDIC’s Division of Resolutions and Receiverships, noted that banks are

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140. *Id.*

141. Gaudet, *supra* note 71, at 29.

142. Witkowski, *supra* note 11. (“‘We have [failed bank] loans that are paying and performing but it’s not a very good loan’ due to the structure, Frawley says, including a lack of interest-rate floors for some loans. ‘We also find that while some of these loans are paying today, they may not be paying tomorrow or the next year.’”).

143. See Telephone interview with James Creekman, Ward and Smith P.A. (Sep. 27, 2013).

144. See Telephone Interview with Lorraine M. Buerger, *supra* note 8.

required by federal law to maximize their recovery; further noting that the accommodation seen from lenders in the past is not to be expected.<sup>145</sup> Thus “any bank with a sizable book of delinquent loans covered under a loss-share agreement should work those assets hard to make sure they have marked their covered loans to their true value and squeezed all the value out of their indemnification assets before their loss-share agreement expires.”<sup>146</sup> If banks fail to take timely action, they may end up “sitting on a block of loans that becomes distressed after the loss-share expires, leaving them with no protection from FDIC.”<sup>147</sup>

The fact that AIs are obligated to comply with the SLAs’ terms for the three-year recoveries-only period following the end of the five-year loss-sharing term serves as further incentive for maximizing loan resolutions prior to expiration. If robust economic recovery was more certain, as was expected when the agreements were executed, and had collateral values correspondingly rebounded, AIs would be more inclined to modify or refinance loans due to the availability of adequate security. Essentially the ability to collect on loss-sharing removes the uncertainty and risk of continuing to workout the covered loans subject to full exposure post expiration.

## VII. BULK SALES

Most CSLAs provide that at the four-year mark the covered assets could be sold with the FDIC’s prior approval.<sup>148</sup> When AIs entered into the agreements, this sale provision was viewed as a backstop to the risk of persisting uncertainty as loss-sharing approached expiration.<sup>149</sup> AIs expected that they would be able to sell at least some of those assets that remained troubled on the eve of expiration and curb any further potential future losses on the covered assets.<sup>150</sup>

At this point, selling covered assets makes a great deal of sense

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145. Singe, *supra* note 16.

146. Stovall & Khan, *supra* note 128.

147. Webinar, *supra* note 17.

148. Quateman & Ginn, *supra* note 13.

149. Webinar, *supra* note 17 (“Bankers had hoped that they could purge their balance sheets after the fourth anniversary of commercial loss-share agreements was reached.”); Telephone Interview with Lorraine M. Buerger, *supra* note 8.

150. *Id.*; see Telephone Interview with Lorraine M. Buerger, *supra* note 8.

for many AIs.<sup>151</sup> Evidenced by the fact the assets were originally procured only under SLAs, banks are not as well suited to carry the effects of full, unprotected exposure to some of these remaining assets as other financial institutions with different appetites for risk may be.<sup>152</sup> The FDIC would benefit from allowing sales because loss-share coverage would not extend to the buyer.<sup>153</sup> Thus, the FDIC would relinquish its obligation to compensate AIs for losses early, potentially saving DIF funds.

Some believe the FDIC is opposed to allowing sales because at least some losses would be guaranteed,<sup>154</sup> while on the other hand, forcing banks to hold on to the assets leaves open the possibility that banks will be able to avoid further losses.<sup>155</sup> In this alleged perspective, the FDIC fails to consider that the losses from sales could potentially be less than losses incurred under SLAs held to term.<sup>156</sup>

Even with these apparent benefits, there is little faith that the FDIC will allow any large portfolio sales.<sup>157</sup> Although there is not a great deal of belief in bulk sales, some industry professionals are not yet foreclosing the possibility. Lisa Greer Quateman views the FDIC's stated intent to establish a committee to review requests for bulk sales<sup>158</sup>

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151. See Telephone Interview with James Creekman, *supra* note 142 (Working loans under a loss-share agreement is very complex. It also time consuming dealing with loans originated by another bank. Additionally, borrowers are very litigious when a shared-loss agreement is involved and it gives them standing for an usually high number of claims.).

152. See Telephone interview with James Creekman, *supra* note 142.

153. See Purchase and Assumption Agreement, *supra* note 85, at 98-101.

154. The FDIC would required under the SLA to pay 80% of the losses sustained by the AI selling the assets and the uncertainty of asset performance (the reason the AI wants to sell) would most likely mean the assets would be sold at a loss.

155. See Telephone interview with James Creekman, *supra* note 142; Telephone Interview with Nathan Stovall, *supra* note 124.

156. See Telephone interview with James Creekman, *supra* note 142; Telephone Interview with Nathan Stovall, *supra* note 124.

157. Telephone Interview with Nathan Stovall, *supra* note 124 (There have been some one-off sales of assets but not any sales of entire portfolios and it does not appear there will be).

158. *State of Community Banking: Is the Current Regulatory Environment Adversely Affecting Community Financial Institutions? Hearing Before the H. Comm. on Financial Services*, 113th Cong. 76 (2013) [hereinafter *Hearing*] (statement of the Federal Deposit Insurance Corporation by Doreen R. Eberley, Director, Division of Risk Management Supervision; Bret D. Edwards, Director, Division of Resolutions and Receiverships; and Richard A. Brown, Chief Economist) ("[T]he FDIC's Loan Sale Advisory Review Committee will review all request for portfolio sales and large individual loan sales to ensure a consistent approach to the approval process . . .").

as a potential indication that such sales will be allowed.<sup>159</sup> The potential exists for the FDIC to merely withhold consent for the time being in order to incentivize AIs to continue to work to maximize recoveries.<sup>160</sup>

### VIII. CONCLUSION

While it is important to understand that AIs are acting within their legal bounds and out of legitimate self-interest, it is equally important to keep in mind the consequences of their behavior on a wider level. The expiration of SLAs introduces an incentive for AIs to off-load loans and collect on the SLA, instead of attempting to pursue modifications—greatly undermining the benefits of the P&A transactions that allowed loans to remain with an institution rather than being liquidated and thus not flooding the market with depressed collateral. Although the real estate markets have recovered to a degree, foreclosures on collateral securing covered assets could result in the resurgence of downward pressure on property prices. Nonetheless, AIs must rationally act in their self-interest and adjust their behavior to recognize now is the time to realize losses.

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159. Webinar, *supra* note 17 (Lisa Greer Quateman is a managing partner at Polsinelli and specializes in capital markets and regulatory matters.).

160. *Hearing*, *supra* note 158.